WELLS FARGO
Investment Institute

Investment Strategy

Weekly guidance from our Investment Strategy Committee — August 2, 2022

Asset Allocation spotlight

Douglas Beath
Global Investment Strategist

The 60/40 portfolio is alive and well

The traditional 60/40 (60% stocks/40% bonds) hypothetical balanced portfolio using the S&P 500 Index and the Bloomberg U.S. Aggregate Bond Index ("Agg") returned -16.1% in the first half of 2022, as both stocks and bonds declined in tandem at double-digit rates. If it holds for the full year, that performance would rank only behind the -21.6% downturn of 2008 during the throes of the Great Financial Crisis, based on the inception date of the Agg in 1976. The 60/40 portfolio also produced negative returns of more than 20% during the two depression-era downturns of 1931 and 1937.

The steep declines so far this year have coincided with an increased correlation between stocks and bonds to 0.6 after being largely negative dating back to 2000. Not surprisingly, several investment pundits have proclaimed that the 60/40 portfolio has become obsolete. In addition to the breakdown of the stock/bond correlation this year, they cite record low interest rates coupled with inflation at 40-year highs for reasons to be skeptical of the traditional balanced approach to managing investment portfolios going forward.

To be clear, what we've witnessed so far this year in capital markets is unusual. Since the inception of the Agg in 1976 through 2021, the S&P 500 has been down in eight calendar years, yet bonds responded each time with positive returns. Similarly, the Agg has been negative four times in its history, but the S&P 500 was higher every time with average annual gains of 20%.

However, while steep declines in the 60/40 portfolio have been rare, they are not unprecedented. The aforementioned 21.6% decline in 2008 and the downturns exceeding -20% in 1931 and 1937 are prime examples. There was also the lost decade that began in the 2000s when the 60/40 portfolio generated a meager 2.3% annual return. Shortly thereafter, PIMCO's Bill Gross declared "The Death of 60/40" in a *Wall Street Journal* article. More recently, Barron's and CNBC have published articles quoting investment professionals who have declared that the 60/40 portfolio has become obsolete.

In contrast, we believe that the 60/40 portfolio and its variations will continue to be an effective strategy for investors, and that reports of the death of the 60/40 portfolio are greatly exaggerated. Key factors that investors should consider going forward include the following:

1. <u>Historical averages of 60/40 portfolios</u> — Since 1976, the 60/40 hypothetical portfolio has generated negative returns over rolling five-year periods on just three consecutive months using data from 2004 to 2009. Over three-year rolling periods, investors experienced negative returns on 25 consecutive months using data from 2003 to 2010. In both the rolling three and five year periods, stocks in every case was the main driver of negative returns averaging -7.8% and -5.2%, versus +6.2% and +4.1% for bonds respectively. Thus, bonds provided a significant hedge during these periods of stock market volatility.

   The math of averages also suggests that a negative period is likely to be followed by positive performance. For example, years when the 60/40 portfolio produced negative returns that exceeded -1% — 1977 (-3.2%), 2000 (-1.1%), 2001 (-3.3%), 2002 (-9.5%), 2008 (-21.6%), and 2018 (-2.3%) — were usually followed by double-digit average annualized returns over the following three years broken down accordingly (see table on page 3):

Time period	S&P 500 Index	Bloomberg U.S. Aggregate Bond Index	60/40
1978-1980	14.4%	2.0%	12.2%
2001-2003	-4.1%	7.6%	1.9%
2002-2004	3.6%	6.2%	5.8%
2003-2005	14.4%	3.6%	10.3%
2009-2011	14.1%	6.8%	11.9%
2019-2021	26.0%	4.8%	17.8%

Source: Bloomberg and Wells Fargo Investment Institute. August 1, 2022. *For illustrative purposes only.* Index returns do not represent investment returns or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions and do not reflect deduction for fees, expenses or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment **Hypothetical and past performance is no guarantee of future results.**

In the rebound phase following calendar years of negative 60/40 performance, stocks outperformed bonds by a significant margin, averaging 11.4% versus 5.2% respectively.

2. Valuation — Recent stock and bond market losses have improved valuations for the 60/40 portfolio. Price-to-earnings multiples have declined from approximately 21x to 17x based on consensus 2022 earnings estimates.[1] In addition, to date, the average yield on the Agg has increased from approximately 1.5% to 3.5% since mid-2021, the fastest one-year jump in yields since 1994.

3. Capital market assumptions (CMAs) – Strategic CMAs[2] include hypothetical return expectations looking out 10 to 15 years covering at least one or more market cycles. Wells Fargo Investment Institute's 2022 CMAs for U.S. Large Cap Equities remained the same as last year, in line with long-term averages. Fixed-income return expectations were increased, allowing for higher inflation expectations to flow through to cash yields and fixed-income returns. (CMA forecasts are not promises of actual returns or performance that may be realized. They are based on estimates and assumptions that may not occur.) The aforementioned stock and bond assumptions (and forecasted correlations) equate to a 60/40 CMA average return of 6.0%, with a standard deviation of 9.3%, compared to an average return of 7.1% and standard deviation of 16.0% for U.S. Large Cap Equities respectively.[3] Thus, projected risk- adjusted returns are significantly higher for the 60/40 balanced portfolio.

4. Risk Reduction – The positive correlations of stocks and bonds this year has tended to be strongest when uncertainty was highest about how high inflation may go. We expect inflation to peak and to gradually decline from a slowing – and even a contracting economy, suggesting correlations could return to negative or close to zero as we observed from 2000 to 2021. Looking ahead, we expect high-quality bonds to provide the traditional diversification benefits both for income – particularly given that yields have risen – and to help reduce downside participation during periods of heavy equity market volatility.

What it may mean for investors

The historical returns of stocks and bonds, combined with more attractive valuations after the recent downturn plus long-term CMA projections, indicate to us that the 60/40 portfolio is alive and well and that it should continue to serve as a solid foundation for long-term investors.

We also believe that a diversified portfolio that includes exposure to Commodities, which has historically tended to rise with inflation, and alternative strategies like Relative Value and Global Macro, with historically low correlations to stocks and bonds can help to hedge against losses and may help to insulate portfolios from additional market volatility.

1. Bloomberg, August 1, 2022.
2. See end of report for CMA methodology.
3. Standard Deviation is a measure of volatility. It reflects the degree of variability surrounding the outcome of an investment decision; the higher the standard deviation, greater the risk.

Equities sector analysis

Sector analysis prepared by Wells Fargo Advisors Global Securities Research

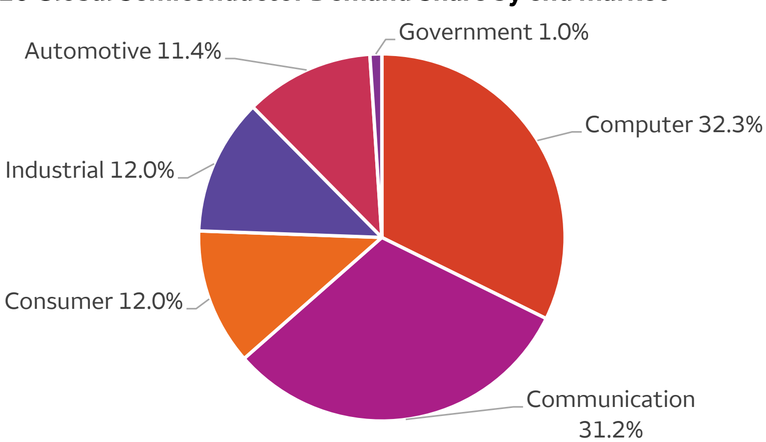
Entering a broad semiconductor down cycle

As the U.S. Federal Reserve aggressively raises interest rates to combat inflation, eventually leading to decelerating economic growth, we believe risks have increased for demand weakness to spread from low-end consumer personal computers and low-end smartphones to other semiconductor end markets within the technology economy at some point later this year or early next year. On the bright side, there are pockets of semiconductor end market strength. For the time being, enterprise Information Technology spending, cloud computing, and data center demand remain relatively healthy. Nevertheless, given relatively high levels of semiconductor inventory in the supply chain and the prospects of decelerating semiconductor sales growth as the economy slows, we believe the risks have increased for an inventory-led correction for the semiconductor industry. Our views were confirmed when the largest semiconductor manufacturing foundry in Taiwan recently shared its forecast of a broad semiconductor down cycle, led by an inventory correction cycle expected to occur from the second half of 2022 through the first half of 2023.

At the peak in early January this year, the Philadelphia Semiconductor Index (SOX) was trading at 26x Next Twelve Month (NTM) earnings and now trades at roughly 16.4x Next Twelve Month (NTM) earnings. Despite the contraction in multiples, most institutional investors continue to expect sell-side analysts to reduce consensus earnings-per-share estimates in the 15% – 20% range before they feel more comfortable revisiting semiconductor equities.

From a sub-industry perspective, within the Information Technology sector, we continue to favor the Semiconductor Equipment, Software, IT Services, and Networking Equipment sub-industries.

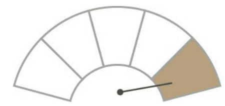
2020 Global Semiconductor Demand Share by end market



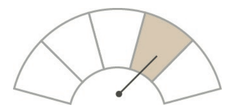
Sources: Semiconductor Industry Association's 2021 State of the Semiconductor Industry Report, 2021...

Amit Chanda
Equity Sector Analyst

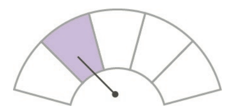
Wells Fargo Investment Institute guidance:



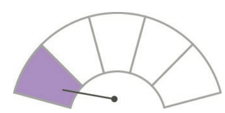
Most favorable
U.S. Large Cap Equities



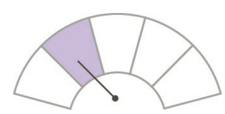
Favorable
U.S. Mid Cap Equities



Unfavorable
U.S. Small Cap Equities



Most unfavorable
Developed Market
Ex-U.S. Equities



Unfavorable
Emerging Market Equities

Fixed Income sector analysis

Sector analysis prepared by Wells Fargo Advisors Global Securities Research

Michael White
Lead Retail Fixed Income Analyst
Wells Fargo Advisors

Eric Jasso, CFA
Senior Retail Fixed Income Analyst
Wells Fargo Advisors

IG corporate bonds entered 2022 from a position of strength

Recession fears have impacted investment-grade corporate bonds as prices have declined and credit spreads have widened. However, some corporate credit metrics are the strongest they have been since 2014.

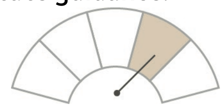
According to Moody's,[4] average corporate debt levels have risen and cash balances have declined in 2022. While on the surface this seems troubling, leverage metrics have actually improved. For the 930 issuers followed, Moody's calculates that average leverage metrics are the strongest since 2014, primarily due to a recovery in earnings and cash flow across the issuer base.

Further, many issuers still have levers to pull in a more severe scenario by reducing buybacks and dividends. Over the past year, Moody's estimates that buybacks and dividends consumed 40% of cash flow for the 930 issuers followed.[5] Curtailing these two uses of cash could provide a significant level of cushion to credit metrics and credit ratings. Global Securities Research favors issuers in Communication Services, Energy, Pharmaceuticals, and Utilities due to their strong credit profiles and cash flows.

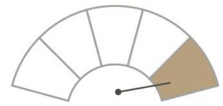
However, there are pockets of risk on the horizon

Some industries are more exposed to economic weakness and not as well positioned financially. S&P highlights a few sectors where the potential for downgrade to speculative grade is elevated over the next 12 months: Hotel, Gaming & Leisure (10% of issuers at risk), Forest Products & Paper (9%), and Consumer Durables (7%).

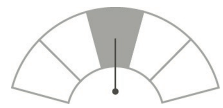
Wells Fargo Investment Institute guidance:



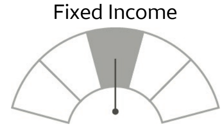
Favorable
U.S. Taxable Investment Grade Fixed Income



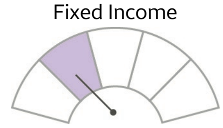
Most favorable
U.S. Short Term Taxable Fixed Income



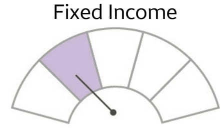
Neutral
U.S. Intermediate Term Taxable Fixed Income



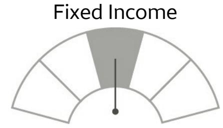
Neutral
U.S. Long Term Taxable Fixed Income



Unfavorable
High Yield Taxable Fixed Income



Unfavorable
Developed Market Ex.-U.S. Fixed Income



Neutral
Emerging Market Fixed Income

4. "Cash pile declines 7% to $2.0 trillion as capex, other spending, hit record highs". July 21, 2022.
5. Ibid.

Real Estate sector analysis

John Sheehan, CFA
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Wells Fargo Advisors

Sector analysis prepared by Wells Fargo Advisors Global Securities Research

How have REIT investors reacted to market volatility?

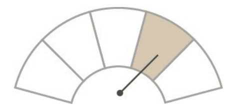
As inflation and market volatility have both increased during 2022, we thought it would be useful to examine how real estate investment trust (REIT) investors have reacted. Examining year-to-date 2022 REIT performance through July 26, we believe REIT investors have adopted a somewhat defensive posture.

As the chart details, the best-performing REIT sub-industry is Freestanding Retail. REITs in this sub-industry typically lease properties under long-term (10+ year) leases that require tenants to pay all of the property operating expenses. The long-term leases provide Freestanding Retail REITs with potential for stable cash flow streams, but only modest internal growth opportunities. Additionally, Freestanding Retail REITs offer an above-average dividend yield of 4.5%. We believe these attributes make Freestanding Retail REITs a relatively defensive REIT sub-industry.

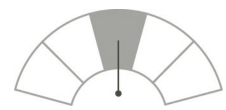
Given the acceleration in inflation during 2022, we would have expected REIT sub-industries with shorter lease durations such as residential (Apartment, Single Family Home, and Manufactured Home) and Self-storage to perform relatively well, given these REITs can adjust rental rates quickly due to their short lease terms. Additionally, we felt investors might also be attracted to REIT sub-industries with better near-term earnings growth prospects such as Industrial and Infrastructure (Tower). While year-to-date returns from Infrastructure (Tower) REITs are modestly higher than the broader REIT sector, as the chart indicates, Apartment, Single Family Home, Manufactured Home, Self-storage, and Industrial REITs have each underperformed the broad REIT sector.

In our opinion, the recent underperformance of several REIT sub-industries may present an opportunity for patient long-term investors to invest in REIT sub-industries we view as having attractive fundamental outlooks.

Wells Fargo Investment Institute guidance:



Favorable
Commodities



Neutral
Private Real Estate

REIT sub-industry performance

	YTD 2022 returns	Yield
FTSE Nareit all equity REITs	-16.0%	3.3%
Freestanding	-1.5%	4.5%
Specialty	-2.0%	4.9%
Health Care	-7.1%	4.1%
Diversified	-7.2%	4.9%
Hotel & Lodging	-9.2%	0.9%
Timber	-11.0%	2.4%
Infrastructure (Tower)	-13.1%	2.4%
Shopping Centers	-14.2%	4.0%
Self-storage	-16.3%	3.0%
Single Family Home	-17.5%	2.3%
Apartment	-18.7%	3.2%
Manufactured Home	-20.6%	2.3%
Industrial	-21.0%	2.5%
Data Centers	-23.7%	2.7%
Office	-25.2%	4.5%
Regional Malls	-34.3%	6.5%

Sources: Nareit/Wells Fargo Advisors, data as of July 26, 2022. YTD = year-to-date. An index is not managed and not available for direct investment. **Past performance is no guarantee of future results. See index definition on page 9.**

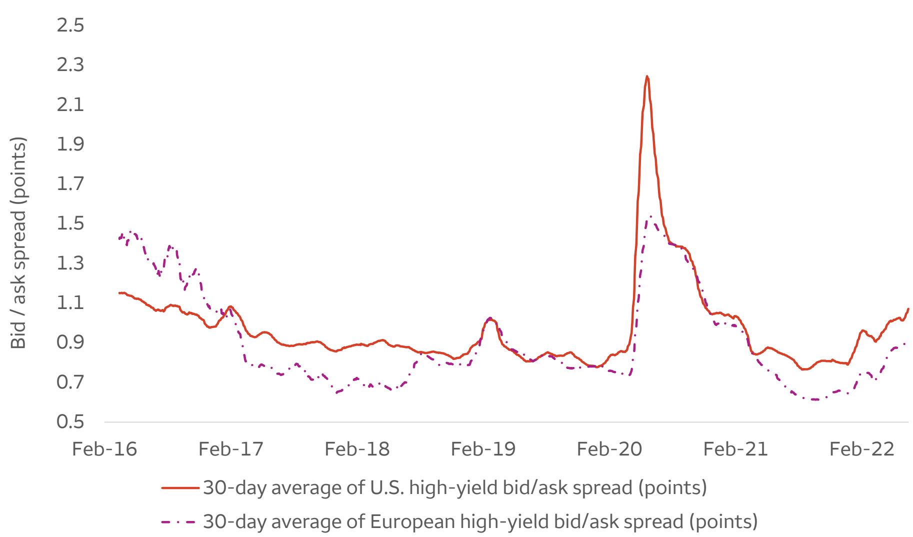
Alternatives

Credit liquidity continues to deteriorate

As the markets grapple with the prospect of recession amid higher inflation, it becomes more and more critical to understand liquidity and how well the financial “plumbing” is working. There are numerous ways that we define and analyze liquidity. Money growth and velocity is but one, alongside key benchmark and overnight rates, as well as cross-border swap spreads and the like. One very important metric is bid-ask spreads, especially those linked with the riskier segments of corporate credit.

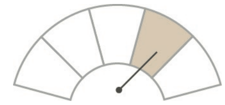
The bid-ask spread is calculated by taking the difference between the ask (offer, or sell) price and the bid (purchase, or buy) price of a security. If the spread is 0, then the asset is extremely efficient and frictionless. Conversely, as the spread — which is often quoted in points — increases, it indicates a wider gap between buyers and sellers, and therefore a reduction in the liquidity of that security. As seen below, bid-ask spreads have had a tendency to widen quickly as panic sets in, such as during the throes of the COVID-19 pandemic. What concerns us at the moment is the gradual widening of bid-ask spreads in both U.S. and European high-yield credit. Though both levels remain far below the first-quarter 2020 spike, they are also above the average seen over the past six years. Liquidity in credit markets is deteriorating, with few reasons to believe it will reverse anytime soon. This poses both a challenge as well an opportunity for hedge funds, as historically they have been willing providers of liquidity during periods of market stress.

High-yield credit bid-ask spreads are trending higher

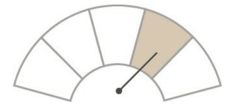


Sources: BofA Global Research/Wells Fargo Investment Institute, High Yield Strategy. Data as of June 30, 2022.

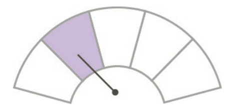
Justin Lenarcic
Lead Wealth Investment Solutions Analyst



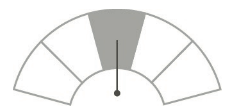
Favorable
Hedge Funds – Relative Value



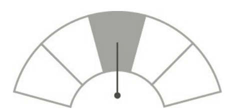
Favorable
Hedge Funds – Macro



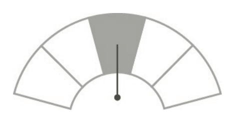
Unfavorable
Hedge Funds – Event Driven



Neutral
Hedge Funds – Equity Hedge



Neutral
Private Equity



Neutral
Private Debt

Alternative investments, such as hedge funds, private equity, private debt and private real estate funds are not appropriate for all investors and are only open to “accredited” or “qualified” investors within the meaning of U.S. securities laws.

CMAs are developed to reflect the expected relationship of capital markets with inflation over one to two market cycles, spanning a 10- to 15-year time horizon. CMAs consist of three distinct parts: hypothetical return, hypothetical risk, and hypothetical expectations for correlations between asset classes. Keep in mind, correlation measures the degree to which asset classes move in sync; it does not measure the magnitude of that movement. Our return and risk assumptions are compared with historical rolling 10-year average returns and standard deviations and generally fall within the minimum and maximum of those ranges.

Risk Considerations

Forecasts, targets and estimates are based on certain assumptions and on our current views of market and economic conditions, which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is appropriate only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Capital market assumptions are estimates of how asset classes and combinations of classes may respond during various market environments. Assumptions are not designed to predict actual performance, and there are no assurances that any estimates used will be achieved.

Definitions

An index is unmanaged and not available for direct investment.

Bloomberg U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

FTSE NAREIT All Equity REITs Index, a subset of the All REITs Index, is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50 percent of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

Philadelphia Semiconductor Index (SOX) is a capitalization-weighted index composed of the 30 largest companies primarily involved in the design, distribution, manufacture, and sale of semiconductors.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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